87-1952

NO.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

RALPH K. VANLANDINGHAM,
PETITIONER

v.

COMMISSIONER OF
INTERNAL REVENUE,
RESPONDENT

PETITION FOR WRIT OF CERTIORARI

TO REVIEW A DECISION OF

THE UNITED STATES COURT OF APPEALS

FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED

FOR REVIEW

WHETHER THE FOURTH CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS HONORABLE COURT BY AFFIRMING THE RULING OF THE TAX COURT THAT THE PETITIONER IN THE INSTANT CASE CANNOT BENEFIT FROM THE NONSEVERABILITY RULE STATED IN THE ESTATE OF MELNICK V. COMMISSIONER, A TAX COURT CASE ALSO INVOLVING THE SALE OF AN ACCOUNTING PRACTICE, BECAUSE IN MELNIK THE "PURCHASE AGREEMENT . . . CONTAINED NO ALLOCATION OF THE PURCHASE PRICE" TO THE COVENANT NOT TO COMPETE."

LIST OF PARTIES

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JURISDICTIONAL STATEMENT

1. The date of the judgment or decree sought to be reviewed is January 4, 1988.

2. The date of the order denying the Petition for Rehearing - Suggestion for Rehearing En Banc is February 25, 1988.

3. The statutory provision conferring on this Court jurisdiction to review the judgment or decree in question by writ of certiorari is 28 U.S.C. Section 2101(c).

APPLICABLE STATUTES

Section 1221 of the Internal Revenue Code of 1954, as amended.

SEC. 1221. CAPITAL ASSET DEFINED

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include-

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by-

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter,

memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by-

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

Section 1202 of the Internal Revenue Code of 1954, as amended.

Section 1202. **DEDUCTION FOR CAPITAL GAINS.**

(a) **In general.-** If for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income.

STATEMENT OF THE CASE

This case came to be heard on appeal by the United States Court of Appeals for the Fourth Circuit Court following the Tax Court's decision in **VanLandingham v. Commissioner**, 56 T.C.M. (P-H), T.C. Memo 1987-66 (1987).

In **VanLandingham v. Commissioner**, the Tax Court addresses the issue of how \$200,000 of \$250,000 to be paid to Ralph K. VanLandingham by Robert Braun upon the sale of VanLandingham's interest in the accounting practice conducted by VanLandingham, Braun & Company, a partnership, is to be allocated for federal income tax purposes.

To the extent that the \$200,000 is allocable to the good will represented by the client base of 300 clients built up by VanLandingham (see Stipulation 13,

Appendix, at IV-13) and not a five year covenant not to compete agreed to by VanLandingham as part of the purchase agreement (see Section 13 of the purchase agreement, **Appendix**, at IV-13), VanLandingham sold Braun an intangible qualifying as a capital asset under Section 1231 of the Internal Revenue Code of 1954, as amended.

To the extent any part of the purchase price is allocable to good will, and, thus, to a capital asset, VanLandingham realizes a long term capital gain of which, pursuant to Section 1202 of the Internal Revenue Code of 1954, as amended, only 40% is taxable while Braun incurs an acquisition cost which is not deductible for federal income tax purposes.

According to Section 2 of the

Agreement, the $200,000 was payable for the

> . . . the remaining interest of VanLandingham in VANLANDINGHAM, BRAUN & COMPANY, consisting of VanLandingham's interest in all intangible assets including but not limited to the right to service all clients, non-competition agreement and client files . . . ."

Appendix, at V-4.

Section 3 of the purchase agreement stated the following:

> VanLandingham agrees to treat the sum of TWO HUNDRED THOUSAND and no/100 DOLLARS 200,000.00) as ordinary income and Braun agree to treat the sum as ordinary deduction.

Appendix, at V-4.

Section 4 of the purchase agreement made the following reference to the allocation of purchase price under Section 2 of the agreement:

> The parties declare that these values were determined in good faith as the result of arm's length bargaining. The parties make the foregoing allocation of purchase price to the capital account of VanLandingham in VANLANDINGHAM, BRAUN & COMPANY, ($50,000.00), and VanLandingham's share in the noncapital assets in VANLANDINGHAM, BRAUN & COMPANY ($200,000.00), with the knowledge and understanding that it will be used by Braun and VanLandingham for income tax purposes.

Appendix, at V-6.

Section 12 of the purchase agreement stated that in connection with the VanLandingham's transfer to Braun of the client base comprised of 300 clients that

> . . . Braun agrees that VanLandingham has given his best efforts in good faith to promote the transfer of clients from VANLANDINGHAM, BRAUN & COMPANY to Braun. Braun acknowledges that VanLandingham has personally talked with all major clients

> of VANLANDINGHAM, BRAUN & COMPANY in Braun's presence to promote the said client transfer and that VanLandingham has mailed a letter approved by Braun to all other clients, a copy of said letter is attached hereto as Exhibit D. Braun agrees that VanLandingham has fulfilled his obligation to promote the transfer of clients.

Appendix, at V-12.

The purchase agreement entered into by VanLandingham and Braun identified $50,000 of the $250,000 purchase price which was paid in cash, at closing or shortly thereafter, as a payment made for VanLandingham's capital account, that is, as a payment equal to VanLandingham's cash investment in the partnership plus any income of the partnership which had been taxed to VanLandingham, but which had not been distributed to him.

The remaining $200,000 payable

under the purchase agreement, the amount at issue, was paid with two notes bearing interest of 7 and 1/2% and requiring principal payments of $13,333 for 15 years.

The issue before the Tax Court, as noted above, was whether the government on audit was correct in allocating this remaining $200,000 to the five year covenant not to compete which VanLandingham entered to as part of the agreement and, accordingly, giving ordinary income treatment to $75,000 received by VanLandingham during the two taxable years in question.

The $75,000 was a settlement amount agreed to by the parties at a time when Braun still owed $160,000 on the notes and was unable to meet the payments required under the notes.

The cash for the settlement was provided by Braun's father who bought the notes from VanLandingham pursuant to an agreement signed by Braun's father, Braun's wife, and Braun which stated that VanLandingham would no longer be restrained by the covenant not to compete and that VanLandingham would treat the $75,000 as capital gain.

The $75,000 was payable in two installments, one in the amount of $21,750 which was paid in the taxable year ending June 30, 1980 and the other in the amount of $53,250 which was paid during the taxable year ending June 30, 1981.

VanLandingham treated both payments as capital gains and, accordingly, on the two returns in question reported a total of $30,000 as taxable gain (40% of

$75,000).

On June 11, 1984, the Commissioner of the Internal Revenue issued a Notice of Deficiency to VanLandingham which in relevant part disallowed the 60% long term capital gains deduction claimed with respect to the $75,000 amount in question. VanLandingham appealed the Commissioner's determination to the United States Tax Court.

In it decision handed down on February 2, 1987, The Tax Court sustained the Commissioner's determination that the entire $200,000 was allocable to the covenant not to compete.

Chief among the Tax Court's finding of facts was the finding that the purpose of the covenant not to compete was to protect the income stream

generated by the extensive client base Braun was purchasing:

> By applying the standard [requiring proof under Virginia law of the existence of a "legitimate business interest"], we find the covenant not to compete is enforceable under the laws of Virginia. **Braun's "business interest" underlying the covenant not to compete was preservation of the income stream generated by the partnership. The purpose of the covenant was to protect that income stream by preventing petitioner from providing competing services in the same general area as existing partnership clients.**

Appendix, at III-19. (Emphasis added.)

The case was appealed to the Fourth Circuit Court of Appeals. The reviewing panel affirmed the Tax Court's decision.

The per curiam opinion of the panel issued on January 4, 1988 affirmed the decision of the Tax Court to allocate 100% of the $200,000 stated

contract price in question to the covenant not to compete. The Court of Appeals described the Tax Court's decision in the following way:

> The Tax Court reviewed the evidence considering the intent of the parties and the economic realities of the transaction. Based on those considerations, it determined that the $200,000 was meant to be allocated to the noncompetition agreement and that this intent reflected the economic realities faced by Braun and VanLandingham in their negotiations. The court therefore concluded that the $200,000 was ordinary income, and the $75,000 paid in lieu of it was the same.

Appendix, at II-3.

The opinion states that the Panel affirms the decision of the Tax Court on the following basis:

> We affirm the Tax Court's decision on the basis of the opinion below and our previous decision in General Ins. Agency v. Commissioner, 401 F. 2d 324 (4th Cir. 1968).

(Id.)

VanLandingham then filed a Petition for Rehearing - Suggestion for Rehearing En Banc. The order stating that the Petition for Rehearing was not granted was issued on February 25, 1988.

SPECIFICATION OF STAGE
OF STATE COURT PROCEEDING

Not applicable.

BASIS FOR FEDERAL JURISDICTION
IN THE COURT OF FIRST INSTANCE

Section 7442 of the Internal Revenue Code of 1986, as amended.

ARGUMENT AMPLIFYING REASONS
OF THE WRIT OF CERTIORARI

I

ARGUMENT

THE FOURTH CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS HONORABLE COURT BY AFFIRMING THE RULING OF THE TAX COURT THAT THE PETITIONER IN THE INSTANT CASE CANNOT BENEFIT FROM THE NONSEVERABILITY RULE STATED IN THE ESTATE OF MELNICK V. COMMISSIONER, A TAX COURT CASE ALSO INVOLVING THE SALE OF AN ACCOUNTING PRACTICE, BECAUSE IN MELNIK THE "PURCHASE AGREEMENT . . . CONTAINED NO ALLOCATION OF THE PURCHASE PRICE" TO THE COVENANT NOT TO COMPETE."

It is respectfully submitted that in affirming **VanLandingham v. Commissioner**, ____ T.C.M. (P-H) 308, T.C. Memo 1987-66 (1987), the Fourth Circuit Court of Appeals "has decided a federal question in a way in conflict with applicable decisions of this Court." **Rule 17.1(c).**

It is, accordingly, respectfully requested that this Court grant a writ of certiorari to review the decision of the Fourth Circuit.

I.A

THE APPLICABLE DECISIONS OF THIS COURT

The applicable decisions of this Court with which the Fourth Circuit's ruling conflicts are the time honored tax opinions handed down in **Eisner v. Macomber**, 252 U.S. 189, 206 (1919), **Weiss v. Stearn**, 265 U.S. 242, 253 (1926), and **Gregory v. Helvering**, 293 U.S. 464 (1935).

In these cases, this Court was engaged in articulating the basic principles to be employed in deciding disputes between taxpayers and the

Commissioner of Internal Revenue.

When **Eisner v. Macomber** was decided, the Sixteenth Amendment to the Constitution of the United States (ending the controversy whether the taxation of income was unconstitutional as an unapportioned, direct tax) had been law for only three years.

One overriding basic principle which found expression in these cases and which has never been abandoned by this Court is the principle that the **substance** of a transaction will govern the tax consequences which follow from it, **not its form**.

In **Eisner v. Macomber**, at 206, this Court, in addressing the issue whether a stock dividend constituted income for federal income tax purposes, stated that whether an item is or is not to be

considered "income" will be decided "**according to truth and substance, without regard to form.**" (Emphasis added.)

Subsequently, in **Weiss v. Stearn**, 265 U.S. 242, 253 (1926) this Court generalized its recognition of the primacy of the substance of a transaction when deciding a case which is determinative of a federal income tax liability by making the following statement:

> Questions of taxation must be determined by viewing **what was actually done, rather than the declared purpose of the participants**; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of **substance** and **not** mere **form**.

(Emphasis added.)

Again, in **Gregory v. Helvering**, the

Commissioner of the Internal Revenue prevailed on the claim that the taxpayer had realized ordinary income rather than long term capital gain (upon the liquidation of a subsidiary created incident to a purported reorganization of the parent corporation) when this Court agreed with the Commissioner that

> ". . . the reorganization attempted was **without substance** and must be disregarded . . ." [and that] "**. . . to hold otherwise would be to exalt artifice above reality** . . ."

Gregory v. Helvering, at 467, 469.

The principle of substance over form as applied in these and subsequent cases is a principle which does not favor either the Commissioner of Internal Revenue. In some cases, it been advantageous to the taxpayer, while in others, its application has been to

the advantage of the Commissioner.

For example, in **Eisner v. McComber** and **Weiss v. Stearn**, deciding the case "according to truth and substance, without regard to form" proved advantageous to the taxpayer, while in **Gregory v. Helvering** it was decidedly to the Commissioner's advantage.

It is submitted that, the Fourth Circuit, in affirming the decision of the Tax Court to withhold from the Petitioner the benefits of the nonseverability rule has "exalted artifice above reality" and has, accordingly, decided a federal question in a way in conflict with applicable decisions of this Court.

In order to properly present this position to the Court, it is necessary first to provide a brief explanation of

the nature, origin, and effect of the nonseverability rule.

I.B.

THE NONSEVERABILITY RULE

The nonseverability rule provides that, in the context of the purchase of a business or an interest in a business where good will is being purchased, if value is given for a covenant not to compete and the purpose of the covenant is to protect the good will purchased, then the covenant not to compete is nonseverable from the good will and, as such, the proper allocation of the price paid for the covenant not to compete should be allocated entirely to the good will.

See **The Estate of Leo Melnik v. Commissioner**, 20 T.C.M. (P-H) 74, T.C.

Memo 1961-18 (1961) [sale of an interest in an accounting practice], affirmed in **Karan v. Commissioner**, 319 F.2d 303 (7th Cir. 1963); **Masquelette v. Commissioner**, 239 F.2d 322 (5th Cir. 1956) [sale of an interest in an accounting practice]; Aaron Michaels, 12 T.C. 17 (1949) [sale of an interest in an accounting practice]; and **Toledo Blade Newspaper Co. v. Commissioner**, 2 T.C. 794 (1943).

The origin of the nonseverability rule is the **Toledo Blade Newspaper Co.** case and it is in this case that the rationale underlying the rule is stated.

In the **Toledo Blade Newspaper Co.** case, of a total purchase price of $880,000.00, a total of $780,000.00 was **expressly allocated** to the covenant not to compete under the written agreement entered into by the parties **and nothing**

was allocated to the good will. **Toledo Blade Newspaper Co.**, at 797.

In addition, the allocation was entered into on the basis of tax consequences which were bargained for between the parties. **Toledo Blade Newspaper Co.**, at 798.

The Tax Court found, nonetheless, that 100% of the purchase price was allocable to the good will because the purpose of the covenant not to compete was to protect the good will purchased.

The court in **Toledo Blade** explained its decision by stating that in a context where the covenant not to compete is entered into "to prevent the seller from destroying the value of the good will of the business transferred", the covenant not to compete becomes "an inherent part" of the good will and

that, consequently, the "entire consideration" received for intangible assets is allocable to the good will. **Toledo Blade Newspaper Co.**, at 806.

In the **Michaels** case, the Tax Court, finding in the context of the sale of an accounting practice that the purchase price at issue was entirely allocable to the good will, explained the **Toledo Blade Newspaper Co.** nonseverability rule by stating that where the purpose of the covenant not to compete is to protect the good will purchased, it becomes in effect "a contributing element to the assets [the good will] transferred" and on this account is nonseverable from the good will. **Michaels v. Commissioner**, at 19.

One commentator cited and paraphrased by the Court of Claims in

Forward Communications Corp. v. United States, 608 F.2d 485 (1979) focusing on the tax effects of the nonseverability rule (see Statement of the Case, p. ___), namely, that the amount at issue while taxable to the seller is nonamortizable or nondeductible by the buyer states that this result is reasonable since the benefit of the covenant is the **continued** (that is, beyond the term of the covenant) enjoyment of the good will.

> One rationale for the application of such test, at least with respect to deductions by the purchaser, as is the issue herein, is that where the goodwill and the covenant are closely related the benefits of the elimination of competition may be permanent or of indefinite duration and hence the value of the covenant is not exhaustible or a wasting asset to be amortized over a limited period. **See 4 J. Mertens, Law of Federal Income Taxation**

Section 23.68 (1973 rev.)
. . . .

Id., at 489.

I.C.
THE RESTRICTIVE STATEMENT OF THE NONSEVERABILITY RULE AFFIRMED BY THE FOURTH CIRCUIT

On appeal to the Fourth Circuit and at trial before the Tax Court, the chief argument of Petitioner was that since the purpose of the covenant not to compete was to protect the good will, it followed from the nonseverability rule as articulated in **Toledo Newspaper Company, Inc.** (and applied in the **Melnick** case in the context of the sale of an interest in an accounting firm) that the $200,000 stated contract price at issue in the instant case was properly allocable to the good will.

In **Melnik v. Commissioner**, the Tax Court found that the entire purchase

price at issue was allocable to the good will purchased. In explaining its decision, the court invoked the nonseverability rule. The court stated, citing the **Michaels** case (another case involving the sale of an accounting practice) and the **Toledo Blade Newspaper Co.** case, that since the purpose of the covenant not to compete was to protect the good will represented by the interest in the accounting firm being purchased, then

> . . . we conclude that the covenant was not severable from the sale of good will and that no separate part of the consideration is attributable thereto.

Melnik v. Commissioner, p. 77.

The Tax Court explained its application of the nonseverability rule by quoting the following from the **Michaels** case:

> But where it [the agreement not to compete] accompanies the transfer of good will in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the purchase the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred. **Toledo Newspaper Co.**, 2 T.C. 794; **Toledo Blade Co.**, 11 T.C. 1079.

Michaels v. Commissioner, at 19.

The question, then, is Why the Court of Appeals **despite a central finding of fact by the Tax Court that the covenant not to compete served to protect the good will** purchased under the agreement affirmed the Tax Court's decision to disregard Petitioner's position that it must as a result of that finding apply the nonseverability rule stated in **Melnik** to the facts of

the instant case? - with the result that the purchase price in question is allocable to the good will represented by client base of 300 clients, not to the covenant not to compete entered into, as the Tax Court found, "to protect the income stream generated by" that client base?

Part of the answer is found in this portion of the Tax Court's opinion affirmed by the Fourth Circuit:

> **Melnik** is . . . **distinguishable from the instant case** . . . [because] . . . the purchase agreement . . . contained no allocation of the purchase price to the assets transferred. **In this case, the sales agreement specifically allocated the purchase price** among two groups of assets, on which was referred to as the "capital account" of VanLandingham and the second of which was referred to as "VanLandingham's share in the noncapital assets in" the company.

Appendix, at III-31. Emphasis added.

An additional source of the application of this restrictive statement of the nonseverability rule is found in the Fourth Circuit case, **General Insurance Agency, Inc. v. Commissioner**, 401 F.2d 324 (4th Cir. 1968).

In that case, a decision not disavowed by the Fourth Circuit in the instant case, the court while citing **Toledo Blade Newspaper Co. v. Commissioner**, stated a similarly restrictive version of the nonseverability rule:

> If the payments [are] for a covenant not to compete they would constitute ordinary income . . . and an amortizable expense . . . [Citations omitted.] However, generally, if such a covenant is not separately bargained for and accounted for and is merely incidental to the

> transfer of the over-all business the seller will be entitled to capital gains treatment of the entire proceeds of the sale but the buyer will get no deduction. **Hamlin's Trust v. C.I.R.**, 209 F.2d 761 (10 Cir. 1954), aff'g 19 T.C. 718 (1953); **Lee Ruwitch**, 22 T.C. 1053 (1954); **Toledo Newspaper Co.**, 2 T.C. 794 (1943).

General Insurance Agency, Co. v. Commissioner, at 329.

This statement of the nonseverability rule by the Fourth Circuit states that the benefit of the rule is available only if the complaining party, in addition to proving that the covenant not to compete serves to protect the good will purchase, also proves that the covenant not to compete is not separately bargained for and is not separately accounted for.

A finding then that a sales

agreement specifically allocated an amount to the covenant not to compete would constitute proof that the covenant was both separately bargained for and separately accounted for - the result being that the nonseverability rule would not be found to be applicable.

This restrictive statement of the nonseverability rule, as will be discussed in detail under I.D., below, completely disregards the rationale of the nonseverability rule as articulated in **Toledo Blade Newspaper Co.**, the case in which the rule originated. As such, as will also be discussed, it is in conflict with the principle announced by this Court in **Eisner v. McComber**, **Weiss v. Stearn**, and **Gregory v. Helvering** that issues relating to the liability for federal income tax shall be decided

"according to truth and substance, without regard to form."

I.D.

The Petitioner submits that this rule contradicts the statement of the nonseverability rule given in the **Toledo Blade Newspaper Co.**, the case in which the rule was originally stated.

In the **Toledo Blade Newspaper Co.** case, the Tax Court allocated 100% ($780,000) of the purchase price at issue despite the circumstances that exactly that amount had been expressly allocated to the covenant not to compete under the sales agreement and that this express allocation was the result of bargaining over tax consequences.

The deciding factor to the Tax Court in **Toledo Blade Newspaper Co.**,

Inc. was that the covenant not to compete was entered into to protect the good will and as such became "an inherent part" of the good will and so should be viewed as nonseverable from it. **Toledo Blade Newspaper Co., at 806.**

Similarly, in **Masquelette v. Commissioner**, where the Fifth Circuit found that the purchase price at issue was entirely allocable to the good will purchased since the covenant not to compete entered into incident to the sale of an accounting practice served

> . . . to assure that the entire good will . . . would be effectively conveyed, . . . the agreement not to compete is a non-severable part of the conveyance of the good will" with the consequence that the purchase price at issue is to be allocated to the good will.

Masquelette v. Commissioner, at ___.

The Tax Court in **Melnik**, citing

Horton v. Commissioner, 13 T.C. 143 (1949), defined good will as being "nothing more than the probability that the old customers will resort to the old place" and, thus, the probability that the income stream generated by those customers or clients will continue uninterrupted.

In **Melnik**, the extent to which an accountant may be viewed as transferring good will was viewed by the 7th Circuit on review as being directly correlated with the extent to which the existing clientele at the time of the sale was attributable to the efforts of the selling partner. **Karan et al. v. Commissioner**, at 306.

In the instant case, Stipulation 13 shows that the client base of 300

clients was attributable to the efforts of VanLandingham and not to Braun, an accountant with three and one half years of experience (see Stipulation 12). **Appendix**, at IV-13.

Given this definition of good will, the Tax Court in the instant case in expressly finding that Braun's business interest underlying the covenant not to compete was entered into to protect the "income stream generated by the partnership" made a finding that the covenant not to compete was entered into to protect the good will.

This finding of fact, fully stated, reads as follows:

> Braun's "business interest" underlying the covenant not to compete was preservation of the income

> **stream generated by the partnership.** The purpose of the covenant was to **protect that income stream** by preventing petitioner from providing competing services in the same general area as existing partnership clients.

Appendix, at III-19. (Emphasis added.)

(The quotation marks around "business interest" were employed by the Tax Court to indicate that its finding tracked the rule of law governing the enforceability of covenants not to compete under Virginia law, a rule which stated that for a covenant not to compete to be enforceable, it must, among other things, protect the "buyer in some legitimate business interest." Id.)

From this central finding by the Tax Court that the business reality of the covenant not to compete is that it serves to protect the good will, it

follows from the **Melnik** decision that the covenant not to compete in the instant case is nonseverable from the good will.

It was because the covenant not to compete served to protect the good will transferred under the purchase agreement, that the Tax Court in **Melnik** " . . . conclude[d] that the covenant was not severable from the sale of good will and that [,accordingly,] no part of the consideration is attributable thereto." **Melnik**, at 77.

Under the Tax Court's application of the rule in **Melnik**, it is not a finding of fact that the underlying business purpose of the covenant is to protect the good will being transferred which is dispositive of whether the covenant is nonseverable from the good

will; what controls on the Tax Court's view as affirmed by the Fourth Circuit is the presence or absence in the purchase agreement of a stated allocation to the covenant not to compete stated in the sales agreement.

If the agreement is silent as to an allocation to a covenant not to compete, then the nonseverability of the covenant from the good will which follows from a finding of fact that the covenant protects the good will results in the purchase price at issue being allocated to the good will.

If, however, the agreement states that the purchase price at issue is allocable to the covenant not to compete, then a finding of fact (the same finding of fact) by the court that the covenant not to compete protects the

good will does not somehow result in the covenant's being nonseverable from the good will.

The specific allocation of purchase price to a covenant not to compete, the purpose of which is to protect the good will, obviously does nothing to alter that purpose; and since it is precisely the circumstance that the purpose of a covenant not to compete protects the good will that results in that covenant's being an inherent part of the good will, such a specific allocation does nothing to alter that covenant's being an inherent part of the good will. The restrictive statement of the nonseverability ignores this circumstance.

In applying the restrictive nonseverability rule by recognizing as

dispositive any specific allocation of purchase price to the covenant not to compete, the Fourth Circuit is allowing mere words to create an independent significance for the covenant not to compete.

A leading commentator, Mertens, gives the same analysis:

> If an agreement not to compete is necessary to effectuate a transfer of goodwill, then the payments made under it may be treated as if made for the sale of a capital asset. It is difficult to understand as a matter of economic reality how, in this kind of case, such a covenant can be anything except "nonseverable" or "ancillary," regardless of whether or not the parties segregate or deal with it as a separate item, since in either event the function of the covenant is to protect the assets transferred and enters into the goodwill . . . .

3B J. Mertens, Law of Federal Income Taxation Sec. 22.33 [p. 303] (____

rev.). (Emphasis added.)

One of the more surprising circumstances arising from this controversy is the government's resistance to the nonseverability rule as stated in the **Toledo Blade Newspaper Co.** case.

One of the most frequent, major business transactions for small businesses, businesses in which, as in this case, considerable good will is present, is the ultimate sale of the business enterprise.

Even though the seller is taxed whether he receives money for good will or for a covenant not to compete, the federal Treasury is allowed to keep the tax paid only if the allocation is to good will. Only then is the money paid by the buyer nondeductible and, thus, is

not paid to the buyer in the form of tax savings.

Where the allocation is to the covenant not to compete, the taxes paid into the Treasury by the seller are paid out to the buyer in the form of tax savings or tax refund.

In affirming the Tax Court's finding, the Fourth Circuit is deciding a federal question in conflict with applicable decisions of this Court, namely, **Eisner v. McComber, Weiss v. Stearn**, and **Gregory v. Helvering**, by allowing the form of a transaction rather than its substance to govern the tax consequences which result from the transaction.

No rule of law could be more dependent on form than the restrictive statement of the nonseverability rule.

and, thus, no rule of law could be more antagonistic to the principles of substance over form stated by this Court in **Eisner v. McComber** and amplified in **Weiss v. Stearn** and **Gregory v. Helvering.**

The Fourth Circuit has affirmed a rule which will result in upholding allocations to the covenant not to compete even where, as in the instant case, the Tax Court makes a **finding of fact** that the buyer's "business interest" is to "protect . . . [the] **the income stream generated by the partnership . . .** by preventing petitioner from providing competing services in the same general area as **existing partnership clients."** **Vanlandingham, Appendix** at III-19.

For the Fourth Circuit to allow

this result by affirming the Tax Court and by not repudiating its own restrictive statement of the nonseverability rule in the **General Insurance Agency, Inc.** case is by elevating form over substance to allow individual taxpayers to determine how tax law will apply to them by contract. A circumstance which this Court has stated it will not allow. **Bartels v. Birmingham, Collector of Internal Revenue**, 332 U.S. 126 (1947). The restrictive statement of the nonseverability upheld by the Fourth Circuit "extols artifice above reality."

CERTIFICATE OF SERVICE

I hereby certify that five true copies of the Petition for Writ of Certiorari was mailed, postage prepaid, on this the 25th day of May, 1988 to Michael L. Paup, Esq., Chief, Appellate Section, Michael Cavalier Durney, Esq., Linda E. Mosakowski, Esq., Gilbert Stephen Rothenberg, Esq., and Margaret Elizabeth Clark, Esq.-at the following address: Tax Division, Department of Justice, P. O. Box 502, Washington, D.C. 20044.

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